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New Developments on the Iraqi Economic Front

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New Developments on the Iraqi Economic Front

Robert Looney*

Introduction

The news of the turn-around and recovery of Iraq's economy first received wide-spread attention following Ambassador Crocker's report to Congress in the fall of 2007. The Ambassador noted that the encouraging news that in some areas improved security was "stimulating revival of markets, with the active participation of local communities. War damage is being cleared and buildings repaired, roads and sewers built and commerce energized."¹ According to the Ambassador:

The IMF estimates that economic growth will exceed six percent for 2007. Iraqi ministries and provincial councils have made substantial progress this year in utilizing Iraq's oil revenue for investment. The 2007 governmental budget allocated \$10 billion (nearly one-third Iraq's expected oil export revenue) to capital investment. Over \$3 billion was allocated to the provinces and the Kurdish Region for spending. The latest data show that spending units (national ministries and provincial councils) have proceeded to commit these funds at more than twice the rate of last year. Doing the best are the provincial authorities, in the process gaining experience with making plans and decisions, and running fair tenders. In so doing, they are stimulating local business development and providing employment. Over time we expect the experience with more responsive local authorities will change Iraqi attitudes towards their elected leaders, and of the provinces towards Baghdad.²

On the other hand the Ambassador went on to note that the "Iraqi economy is performing significantly under potential." Insecurity in many areas resulted in increased transport costs which raised the cost of production and limiting the size of markets for critical agricultural and manufacturing

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¹Ambassador Ryan C. Crocker, "Report to U.S. House of Representatives on the Situation in Iraq," U.S. Department of State, September 10, 2007. <http://www.state.gov/p/nea/rls/rm/2007/91941.htm>.

²Ibid.

goods. While electricity supply improved in many parts of the country, it was still insufficient to jumpstart the economy of Baghdad and its environs. Many neighborhoods in the city received two hours of electricity a day or less from the national grid, although power supplies for essential services such as water pumping stations or hospitals were much better.

Poor services are not the only cause of dissatisfaction and frustration among the Iraqi population. As Frank Gunter has observed, "many Iraqis in and out of the government compare today's living standards to those of the oil boom of thirty years ago." Unfortunately after a failed take-off in the 1970s, Iraqi per capita incomes are back where they were in 1950.

As for the U.S. economic strategy in Iraq, Ambassador Crocker implicitly acknowledged a shift from the failed top-down, large infrastructure project approach that characterized the initial economic strategy to one focused on local development, and community-based support programs:

We are deploying our assistance funds to make a difference to ordinary Iraqis and to support our political objectives. Military units are using Commanders Emergency Response (CERP) funds to ensure that residents see a difference when neighborhood violence declines. USAID Community Stabilization Funds provide tens of thousands of jobs. With the recent apportionment of 2007 Supplemental funds, we are putting "Quick Response Funds" in the hands of our Provincial Reconstruction Team leaders to build communities and institutions in post-kinetic environments. Vocational training and microfinance programs are supporting nascent private businesses. And in Baghdad, we are increasing our engagement and capacity building efforts with ministries.³

On the surface, Ambassador Crocker's assessment suggested that the shift in U.S. economic strategy in Iraq was finally on the road to successes after years of accomplishing little in the way of tangible gains in employment and improved standards of living for the vast majority of Iraqi citizens. Looking back on Ambassador Crocker's assessment from the vantage point of a year later, was his optimism warranted? Or, are there still serious problems lurking beneath the surface? Are there other forces at work that cast doubt on the sustainability of the country's recent economic successes?

Progress from a Macroeconomic Perspective

Much of the optimism concerning the Iraqi economic recovery came from an International Monetary Fund (IMF) assessment of progress made under the country's Stand-By-Agreement with the Fund.⁴ While the fund

³Ibid.

⁴Staff Report for the 2007 Article IV Consultation, *Fifth Review under the Stand-By Agreement, Financing Assurances Review, and Requests for Extension of the Agreement* (Washington: International Monetary Fund, July 18, 2007).

projected an economic expansion of 6 percent in 2007, it was with a number of caveats and uncertainties. Iraq is still an oil based economy, so the six percent growth rate is based on the assumption of a modest increase in oil production—reaching 2.1 million barrels per day (mbpd) with stable prices. However, the Fund goes on to note that:

The economy remains extremely vulnerable to the country's security problems, which impede investment, inhibit private economic activity and hamper implementation of the structural reform agenda. In the event that investment and production in the oil sector cannot be increased as projected, lower oil revenue would result in higher fiscal deficits and sizable financing gaps from 2008. Absent access to significant external borrowing, spending cuts would be necessary and unavoidable. The debt sustainability analysis indicates that Iraq's external debt remains also vulnerable to negative oil and rice production shocks.⁵

In short, the Fund's forecast of 6 percent rate of growth was under the assumption that no major unanticipated negative shocks hit the economy. If this did occur, the Fund cautions that the Iraqi authorities could do little to stem their adverse effects. The result might be a rate of growth considerably below 6 percent.

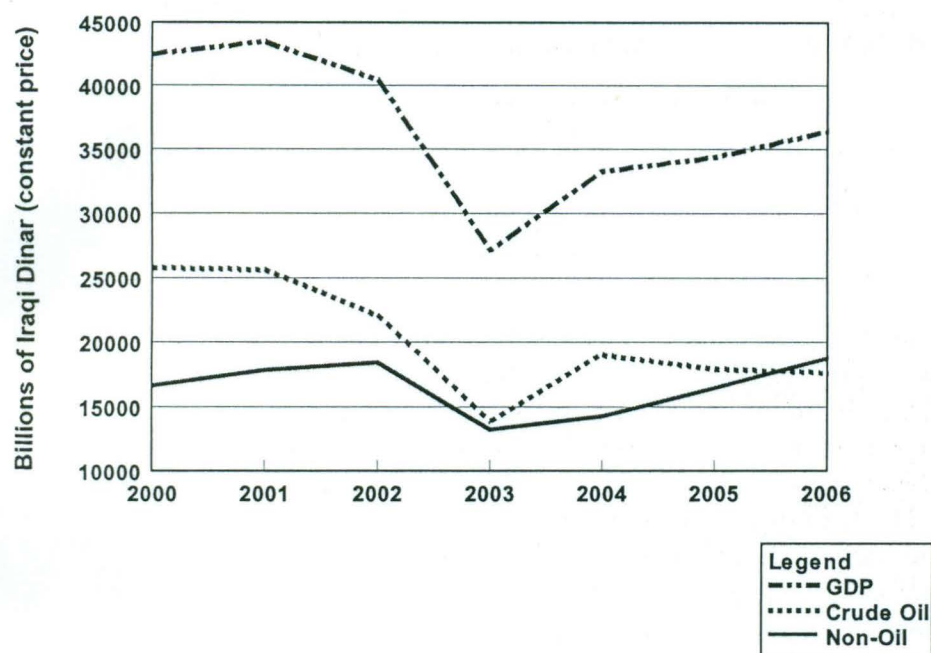
The IMF report also presented one of the more complete sets of data on the Iraqi economy. The disaggregated macroeconomic data revealed several interesting trends that also raise questions on the sustainability of the country's recent economic expansion. While the quality of Iraqi data is always in question, there are several distinctive trends that even errors in the data cannot conceal. Given the slow expansion in oil production and its unfulfilled potential,⁶ the economy has had to rely to a certain extent on an expansion in the non-oil economy (Figure 1).

⁵Ibid, pp. 13-14.

⁶"Unfulfilled Potential," *Middle East Economic Digest*, 51:8, May 4, 2007, p. 6.

Figure 1

Iraq: Trends in Gross Domestic Product and Main Components



As things turned out, the IMF forecasts were on the cautious side. Crude oil production and exports, which had stagnated during 2005 and 2006 rose during the second half of 2007 and have continued expanding through the summer of 2008. Rising output along with the high price of oil should increase Iraq's oil revenues to nearly \$80 billion in 2008.

What are the chances of a continued expansion in oil revenue, with perhaps major increases over the next five to ten years? Much depends on the manner in which the country's controversial draft hydrocarbons law is resolved. Will it be approved by the Parliament? If it is signed, will oil companies flock to the country, bringing the technology and billions of investment dollars needed to revive the industry?⁷ Since signing the draft law is part of the benchmarks for progress laid down by the U.S. Congress, it will undoubtedly become law eventually. On the other hand, the prospects are not particularly bright for an infusion of new investment into the dilapidated industry.

⁷"Dividing the Wealth," *Middle East Economic Digest* 51:18, May 4, 2007, pp. 4-5.

the reported growth rates are biased upwards because they do not reflect "new" output, but simply a reclassification of existing production from informal (where they are not counted) to formal (where they are counted).

Agriculture

Iraq was once self-sufficient in food, but the agricultural sector has been on the decline for years. The sector accounts for about 25 percent of the workforce, but suffers from years of neglect. Much of the once state of the art irrigation system is crumbling, soil salinity is a major problem, and in many localities there has been a serious lowering of the water table.

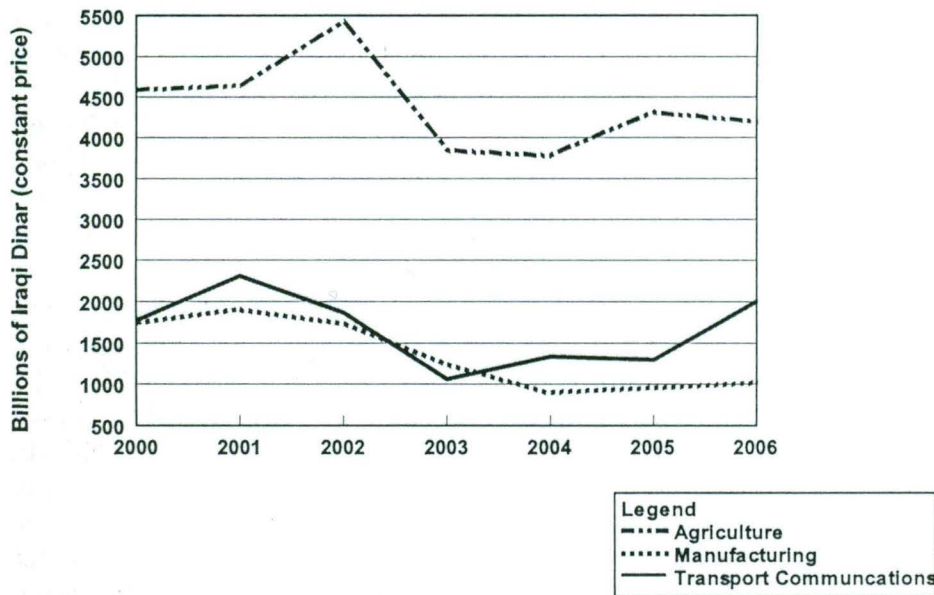
Under Saddam prices of inputs and outputs were largely government controlled. Production dropped dramatically in 1997 following the shift to cheap imports associated with the Oil for Food Program. To date the post-Saddam era has seen little overall-change in Iraq's agricultural policy.

According to a joint survey by the Food and Agriculture Organization (FAO) and the World Food Program, the overthrow of Saddam Hussein in 2003 had little immediate effect on the agricultural sector. Especially in the north, agriculture was virtually untouched, and, elsewhere, all husbandry practices and field operations except harvesting had already been carried out when the war started in mid-March, and hostilities were over by mid-April before the harvest had begun.

Within the productive sectors this shift from informal to formal activity is probably the highest in agriculture, where farmers can transition from self consumption and local barter to more formal markets as the rural security situation improves and distribution networks are revived. The IMF data (Figure 2) show that the non-oil sector is dominated by agriculture. Here expansion has been weak, with production not yet returning to the levels achieved in the last years of the Saddam Hussein regime. More troubling is the fact that there does not appear to be a strong recovery underway, with output actually falling in 2006. This pattern is particularly disappointing because, of the productive sectors, agriculture probably has the highest long-run growth potential. Given that a large percentage of the population is dependent on agriculture for their livelihoods, a broad based economic expansion on the supply side is unlikely until the sector recovers.

Figure 2

Iraq: Trends in Major Productive Sectors



Source, Compiled from: International Monetary Fund, *Iraq: Statistical Appendix*, IMF Country Report No. 07/294 (Washington: International Monetary Fund, August 2007), p. 3.

While droughts have been partially responsible for the sector's problems, the fact remains that no coherent agricultural policy has emerged. U.S. officials would like to increase the yield on farmland still in production and see Iraq move toward a free-market system. But Iraqi agricultural officials contend that crucial resources are too short for markets to make a quick transition into the world market. The Ministry of Agriculture continues to pay more than \$200 a ton for wheat, more than the price in international markets, contending that the phase-out in price supports should be done over a 10-year period.¹⁰ While the debates and inaction continue, early indications are that production in 2008 will be especially disappointing, owing to a combination of poor rains and sharp freezes in the winter.¹¹

¹⁰Doug Smith and Raheem Salam, "Dust Bowl Uncertainty Grows in Iraq; Farm Production has Fallen Below Prewar Levels. Without a Plan to Revive the Agricultural Sector, A Nation's Identity may Wither, Officials Say," *Los Angeles Times*, April 15, 2006.

¹¹*Iraq: Country Profile 2008* (London: Economist Intelligence Unit, 2008), pp. 22-23.

Manufacturing

Progress in the critical manufacturing sector has also been disappointing. The sector has been on the decline for some time with the ailing state enterprises of the Saddam Hussein regime increasingly unable to maintain production levels. The sector's contraction leveled off in 2004 with little or no expansion in the last several years. One new U.S. initiative under the direction of Paul Brinkley¹² the Under Secretary of Defense for Business Transformation is to jump-start the sector by opening up a number of old state enterprises, many of which have been shut for years due to their high costs, uncompetitive outputs or stripped assets.

Resurrection of the country's state owned enterprises does have its supporters. Fareed Zakaria contends that it would cost only \$100 million to restart all of Iraq's state companies: "That's as much as the military will spend in the next 12 hours."¹³ Still, the program has been extremely controversial with the State Department and the Defense Department each adamantly opposed to the project at one time or another. There has been no period when both were whole-heartedly behind the project. Lack of cooperation between U.S. government agencies will no doubt ultimately doom the project. As Rajiv Chandrasekaran recently observed:¹⁴ "Paul Brinkley, a deputy undersecretary of defense has been called a Stalinist by U.S. diplomats in Iraq. One has accused him of helping insurgents build better bombs. The State Department has even taken the unusual step of enlisting the CIA to dispute the validity of Brinkley's work." Given the history of this program it is no surprise that it is currently fraught with problems.

...the implementation of that strategy has proved far more complicated and controversial than anyone expected. Money to get the factories restarted has been hard to come by. Finding buyers for the goods in the U.S. has been even harder (only one company, a small Memphis retailer, has signed on so far). And that's on top of the Herculean challenges of doing business in a war zone where electricity is erratic, supplies are scarce, and employees can get blown up on the way to work.¹⁵

The Bremer-Brinkley debate over Iraq's SOEs has raged on with advocates of opening advancing additional rationales while those opposed have doggedly cited the many disasters associated with SOEs in the former

¹²See his "A Cause for Hope: Economic Revitalization in Iraq," *Military Review* 87:4 July/August 2007, pp. 2-11.

¹³Fareed Zakaria, "The Surge that Might Work," *Newsweek*, August 21, 2007.

¹⁴Rajiv Chandrasekaran, "Defense Skirts State in Reviving Iraqi Industry," *Washington Post*, May 14, 2007, p. A.1.

¹⁵Barney Gimbel, "One Man's Mission Impossible," *CNNMoney.com*, September 4, 2007. http://money.cnn.com/2007/08/31/magazines/fortune/iraq_inc.fortune/index.htm

Communist countries of Central and Eastern Europe as well as the former Soviet Union. As one astute observer has noted:¹⁶

Who is right in the Bremer-Brinkley state owned enterprise (SOE) controversy? Brinkley is right in that in the short-term rapidly providing jobs should reduce support for the insurgency. But this favorable impact requires that the jobs be forthcoming in a reasonable period of time. Despite many optimistic announcements, few new SOE jobs have been created in the first year of the program. Bremer is right that in the long-term a vibrant free market is more likely to provide enough jobs in the future for the large number of young Iraqis. But efforts to liquidate or privatize SOEs have stalled and, especially since the 2005 elections, the United States' ability to pressure the Government of Iraq into liquidation or privatization has decreased.

As things turned out, over the year beginning in June 2007, dozens of state-owned enterprises have cautiously re-opened for business after years of neglect. The Iraqi government wants a cash injection of more than \$2 billion to turn round the fortunes of 42 of the best performing SOEs, including a Glass and Ceramics factory in Ramadi. Still questions remain as to the viability of these firms. At a conference in Dubai in May 2008, 42 SOEs were put up for joint venture contracts, a halfway house between state ownership; and full privatization. None attracted bids.¹⁷

Other Sectors

In other sectors of the economy, the increase in income derived from transport and communication suggests that the rebuilding efforts have created a number of linkages with the non-oil economy, perhaps laying a foundation for further growth. In fact, Ambassador Crocker noted that the expansion in cell phones was one of the major indicators of economic success in the country. As he observed "An auction of cell phone spectrum conducted by PricewaterhouseCoopers netted the government a better than expected sum of \$3.75 billion."

Again caution must be exercised in interpreting these trends and translating them into indicators of economic success. Brian Beutler¹⁸ has summarized other interpretations of increased cell phone usage:

The cell phone market in Iraq is indeed growing fast, and it's that market that drove competition for the country's wireless spectrum at last month's auction. But a rapidly growing cellular market is both difficult to quantify and, ironically, can be a sign of economic weakness. Alex Rossmiller worked in Iraq as an intelligence office for the

¹⁶Frank Gunter, op.cit., p. 7.

¹⁷Jack Fairweather, "State Enterprises Cautiously Reopen," *Financial Times*, June 17, 2008

¹⁸Brian Beutler, "Crocker's Fuzzy Economics," *MotherJones.Com*, September 13, 2007. http://www.motherjones.com/cgi-bin/print_article.pl?url=http://www.motherjones.com/news/update/2007/09/ryan-crocker-fuzzy-economics.html.

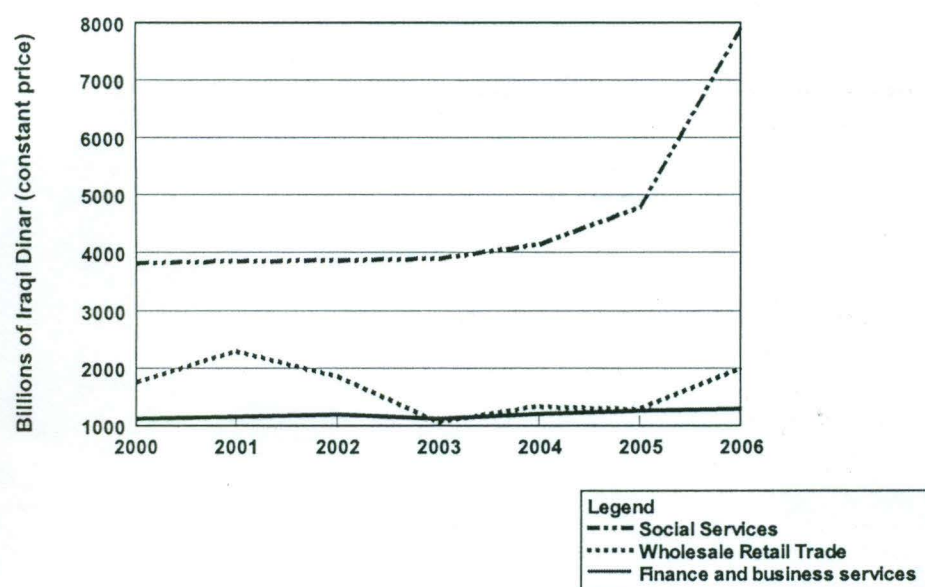
Department of Defense. He says "cell-phone use in Iraq is skyrocketing, primarily because the land-line infrastructure is so degraded, both from neglect during Saddam's rule and from our military operations against communications facilities in 2003." Similarly¹⁹

Daniel Sudnick, who worked at the Coalition Provisional Authority as Paul Bremmer's senior adviser for communications, described it as an "irony" that part of the reason the cell phone industry has flourished is that resistance fighters don't often attack towers and other cell phone infrastructure, for a simple reason: They depend upon mobile phones, too. Moreover, Sudnick says the unstable monthly contracts are evidence of a broken system. "The economic reality in Iraq hasn't changed fundamentally since I've been there. They don't have a reliable, robust banking system over there. It's still a cash economy. And the only way to retain payment is with a prepaid system."

Finally, the pattern of growth in the service sectors reveals the private sector's lack of dynamism. The growth in retail/wholesale trade as well as financial services has been particularly flat, with oil revenue and aid financed social services accounting for nearly all of the expansion in this sector's activity (Figure 3).

Figure 3

Iraq: Trends in the Service Sectors



Source, Compiled from: International Monetary Fund, Iraq: Statistical Appendix, IMF Country Report No. 07/294 (Washington: International Monetary Fund, August 2007), p. 3.

¹⁹Ibid.

The main consequence of the private sector's sluggish growth is high unemployment rates that have become chronic. Estimates vary, with unemployment figures ranging anywhere from 20-50 percent. Regardless of the exact magnitude of unemployment, there is little evidence of significant reductions taking place over the last several years. High unemployment has long fed Iraq's violence. The decision to disband Saddam Hussein's army, in particular, left thousands of men out of work, pushing many into the insurgency, militias, and increasingly violent criminal gangs.²⁰ Even with violence at its lowest level in four years, the problems noted in agriculture and manufacturing noted above suggest reducing unemployment won't be simple.

For its part, the Iraqi government launched a job-creation program in early 2008. Baghdad officials alone are hiring as many as 4,000 people a day, paying most a small daily rate to clean streets, do repair work and complete other small tasks like painting signs.²¹ Many provinces have similar programs, but in smaller numbers. Clearly this is only a temporary solution and it remains to be seen how long the current period of relative stability can continue without a significant improvement in the employment situation.

Finally, Ambassador Crocker's report to Congress did not touch on the corrosive effect inflation is having on the economy. The consumer price index rose by 30.5 percent year-on-year in July 2007, with the fuel component of the index rising by 90.2 percent. As with any inflation, fixed income groups in Iraq are suffering the most. In venting their anger at the government, the effected groups will no doubt create even more political instability. Reconstruction efforts are also being distorted by the rise in local prices and higher labor costs (in dollar terms). Since the majority of government spending is denominated in dinars, more oil export earnings (denominated in dollars) are required for any given item. "This is making the use of non-Iraqi regional manpower more attractive as it is cheaper than employing an Iraqi workforce, thereby undermining economic regeneration."²²

While the government has been able to bring the rate of inflation down to around 15%, many of its distorting effects remain. In addition, the government has fought inflation largely through a policy of revaluing the Iraqi

²⁰Cf. Robert Looney, "Socio-Economic Strategies to Counter Extremism in Iraq," *Journal of South Asian and Middle Eastern Studies* XXIX:2 (Winter 2006), pp. 21-44.

²¹Sally Buzbee, "Iraqis Face Unemployment Hurdles," *Associated Press*, July 18, 2008

²²"Iraq: Inflation Undermines Reconstruction and Reforms," *Oxford Analytica*, September 7, 2007, p. 1.

dinar—thus making imports cheaper. Although expedient, this policy has only created another set of distortions—the so-called “Dutch Disease” whereby an overvalued currency discourages the production of traded goods and shifts resources to service activities. The longer-term effect compounds even more the problems noted above in re-starting agriculture and manufacturing.

Progress From a Regional Perspective

While the macroeconomic perspective provides some insights, both encouraging and discouraging, as to the nature of economic progress to date, one does not get a sense of the geographic dimension of activity. Clearly all parts of the country are not making comparable strides in reconstruction or recovery. As Ambassador Crocker correctly implied improved economic conditions quickly follow political and security successes.

In al-Anbar, the progress on the security side has been extraordinary... Tribal representatives are on the provincial council, which is now meeting regularly to find ways of restoring services, developing the economy, and executing a provincial budget. These leaders are looking for help to rebuild their cities and talking of attracting investment. Such scenes are also unfolding in parts of Diyala and Ninewa, where Iraqis have mobilized with the help of the Coalition and Iraqi security forces to evict al-Qa'ida from their communities. The world should note that when al-Qa'ida began implementing its twisted vision of the Caliphate in Iraq, Iraqis, from al-Anbar to Baghdad to Diyala, have overwhelmingly rejected it.

However, he goes on to warn that success is far from automatic:

A key challenge for Iraqis now is to link these positive developments in the provinces to the central government in Baghdad. Unlike our states, Iraqi provinces have little ability to generate funds through taxation, making them dependent on the central government for resources. The growing ability of the provinces to design and execute budgets and the readiness of the central government to resource them are success stories. On September 5, Iraq's senior federal leadership traveled to al-Anbar where they announced a 70% increase in the 2007 provincial capital budget as well as \$50 million to compensate losses in the fight against al-Qa'ida. The support of the central government is also needed to maintain hard-won security in areas like al-Anbar through the rapid expansion of locally-generated police. The Government of Iraq has placed some 21,000 Anbaris on police roles.

An independent assessment made by Stuart W. Bowen, the Special Inspector General for Iraq Reconstruction (SIGIR), also notes some bright spots:²³ economic growth in the Kurdish north;²⁴ tribal reconciliation in the

²³Statement of Stuart W. Bowen Jr. Special Inspector General for Iraq Reconstruction before the United States House of Representatives committee on Armed Services Subcommittee on Oversight and Investigations, “Effectiveness of the Provincial Reconstruction Team Program in Iraq,” October 18, 2007.

²⁴A good account of the Kurdish economic boom is given in John Irish, “Iraq's Building Hotspot,” *Middle East Economic Digest* 51:8, February 23, 2007, pp. 51-53.

western desert province of Anbar; and patchy progress in the development of local governments. Beyond that, some of the provinces are showing increasing ability to create plans, write contracts and carry out construction projects to rebuild Iraq's physical infrastructure.²⁵ Skill shortages are, however impeding progress in many local governments and ministries.²⁶

Unfortunately, many factors are still impeding progress in key areas across the country. For example:²⁷

- the failure of the Council of Representatives to pass a provincial powers law that defines local governments' rights and responsibilities has limited provincial councils' effectiveness in managing their governmental institutions;
- weak and uncoordinated rule of law programs within the provinces and at the national level have been a continuing problem. In most provinces, there is little cooperation;
- among the police, courts, and correction facilities, judicial orders are routinely ignored;
- efforts to increase local living standards and reduce unemployment have been undermined by the dangerous security situation, but micro-lending programs, agribusiness development, and small-business development programs are beginning to make headway;
- provincial governments have limited capacity to manage and sustain infrastructure and to budget for operations and maintenance, but some improvements have been noted in Iraqi management of local reconstruction projects; and
- local political reconciliation efforts have been undermined in some areas by rival Shia groups, a sense of alienation among Sunnis, and growing frustration over the inability to obtain government services.

²⁵ A good summary of the Bowen report is given in James Glanz, "Head of Reconstruction Teams in Iraq Reports Little Progress Throughout the Country," *New York Times*, October 18, 2007.

²⁶ "Skill Shortage Halts Progress," *Middle East Economic Digest* 51:17, April 27, 2007, p. 21.

²⁷ *Ibid.*, p. 2.

At the risk of over-generalizing, the overall picture is one of high investment and rapid increase of incomes in the Kurdish regions, promise of stability and improved prospects in the Sunni region of Al-Anbar, and continued stagnation in Baghdad with limited pockets of progress in the Southern provinces.

The development of distinct regional or local economies has long been a concern to those desiring Iraq to be a strong, unified nation state. A recent study by Blomberg and Engel²⁸ found considerable evidence of localized activity. Their study analyzed weekly price data for 255 goods from the eighteen Iraqi governorates over the years 2005-2008 to assess the extent that markets are development. As they note, the law of one price suggests that, after controlling for distance between major cities, prices should converge in the presence of relatively free trade among the governorates.

Their model suggests four empirical regularities associated with market development in Post-War Iraq. First, the degree of price distortion (i.e. price dispersion) has been approximately two times higher than those reported using similar techniques and data in the United States and Japan. Second, the degree of price distortion drops significantly during the period commonly referred to as "the surge" and rises afterward, though at a more modest pace. Third, the degree of price distortion is significantly smaller in areas in which the United States military presence was greatest, i.e., Sunni and Kurdish regions as opposed to Shia regions. Finally, there is limited evidence to suggest that the sub-national economies (Kurdish, Shia, and Sunni) are not completely economically integrated, though the "border effects" are smaller than those reported across countries in the trade literature. From these results, they conclude that there are "lines in the sand" rather than significant border impediments. "Taken together, these results suggest a significant role for violence and security in explaining market distortions and market integration and disintegration."²⁹

One danger of the development of distinct regional economies is the balkanization of Iraq, which may in the long term impede efforts to consolidate the country around a strong central government. There are already an increasing number of examples of provinces defying the central government through such actions as withdrawing their electricity generation from the national grid.³⁰

²⁸S. Brock Blomberg and Rozlyn C. Engel, "Lines in the Sand: Border Effects, Economic Integration and Disintegration of Post-War Iraq," July 25, 2008

²⁹Blomberg and Engel, op. cit., p. 1.

³⁰"Iraq: Infrastructure Seizure Reflects Central Power Ebb," *Oxford Analytica*, August 29, 2007, p. 1.

Progress From an Economic Reform–Governance/Institutional Perspective

As noted above, Iraq is beginning to make some economic progress. While much of the country's recent economic growth can be attributed to improved oil prices and to a lesser extent production volumes, the sustainability of this growth is likely to depend on the ability of the country to press ahead with economic reforms and the development of supporting institutions. There is much work to be done:

The Iraqi central government's administrative capacity and the country's economic progress still lag far behind the gains in security, and there is still much to be done before Iraq has a mature political system and a productive economy capable of meeting the Iraqi people's basic needs. The Iraqi government has proved unable to spend more than a modest fraction of its own revenue, leaving the Iraqis largely unable to benefit from record-high oil prices. Unemployment is between 30 and 40 percent and there has been little documented progress in providing health care, education, sanitation, clean water, or most other services.³¹

The progress that has occurred has been largely in the area of economic reforms.³² In trade for example, Iraq applied a flat tariff rate of 5 percent in 2004. However, non-tariff barriers include significant delays in trade through customs as well as some import and export bans.

Tax wise, the business climate was made favorable by capping both individual and corporate income tax rates at 15 percent. Despite slow progress, some structural reforms, including steps to reduce subsidies and modernize government financial management, have been made. Further modernization of the tax system and introduction of a sales tax are under currently under review.

The elected Iraqi government created a new investment law in October 2006, opening Iraq to foreign capital. Inflation and sluggish growth, combined with a deleterious security situation and rampant corruption, are major hindrances to investment. Iraq does not subscribe to international arbitration agreements, although it does have a domestic arbitration framework. The regulatory system is confusing, since most of the laws are new, having been established by the 2006 investment law, and thus fairly ambiguous for investors. Capital and profits can be transferred out of Iraq. Laws concerning state expropriation are not fully formed, though the constitution reserves the power for national interest situations.

³¹Stephen Biddle, Michael E. O'Hanlon and Kenneth M. Pollack, How to Leave a Stable Iraq, *Foreign Affairs*, September/October 2008.

³²The following review of economic reforms draws heavily on Index of Economic Freedom, 2008 (Washington: Heritage Foundation, 2008)

The Coalition Provisional Authority and the new Iraqi government have introduced many changes into Iraq's financial system. A March 2004 banking law significantly liberalized and modernized the banking system, allowing credit to be allocated on market terms and making the central bank independent.

Unfortunately, in the critical area of property rights, not much progress has taken place to date. For all practical purposes, there is no protection of property in Iraq. Ongoing wartime conditions and a high degree of personal insecurity discourage investment. The absence of an enforceable legal system means that foreigners are further disadvantaged in terms of dispute resolution, although this affects local investors to a large degree as well. U.S. forces, working with Iraqi military and police units, are trying to improve conditions but still face daunting challenges.

Many of the difficulties encountered in carrying out economic reforms stem from the country's lagging institutions and governance structures. At the broadest level, institutions can be defined as the structure of incentives that promote or impede entrepreneurial services and productive investment. In many empirical studies, institutions are often measured by the extent to which governments are effective in promoting respect for the rule of law, contract enforcement, and the protection of property rights.

A number of organizations, such as the Political Risk Services Group, the World Bank, and the World Economic Forum, have developed surveys to measure over time the effectiveness of government institutions across a range of emerging market and industrial countries. These surveys typically score countries on an annual basis according to a variety of indicators, such as control of corruption, government effectiveness or bureaucratic quality, regulatory quality, political stability, and democratic accountability.

These measures of government institutional capacity show clear weaknesses for the Middle East/North Africa (MENA) region as a whole, and in some cases for the neighboring GCC oil producing countries. Several elements of government institutions that stand out in Iraq and the region are captured in the World Bank data set, which presents a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000, 2002, 2003, 2004, 2005, 2006, and 2007. In looking at Iraq's progress in the main areas of governance, it is useful to compare them to those achieved in the entire MENA area as well as those in the GCC. The World Bank data set's six dimensions of governance are:

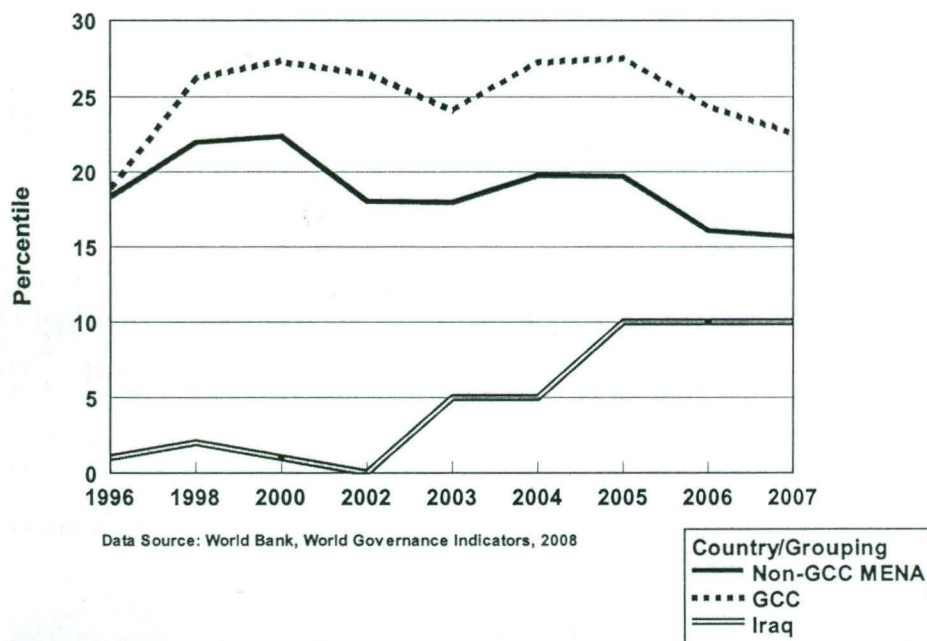
Voice and accountability. This variable measures various aspects of the political process, civil liberties and political rights. These indicators

demonstrate the extent to which the citizens of a country are able to participate in the selection of government. Also included in this variable are indicators measuring the independence of the media.

While Iraq certainly lies below the norm for the region, some progress has been made since the overthrow of Saddam (Figure 4). On this dimension, the country has risen from the 0 percentile in 2002 to the 10th percentile in 2007—i.e. 90 percent of the world's countries have achieved better progress in this area. Still the country's score in this area has been rising, while in recent years both that of the MENA and GCC countries has been falling.

Figure 4

Progress in Governance: Voice and Accountability

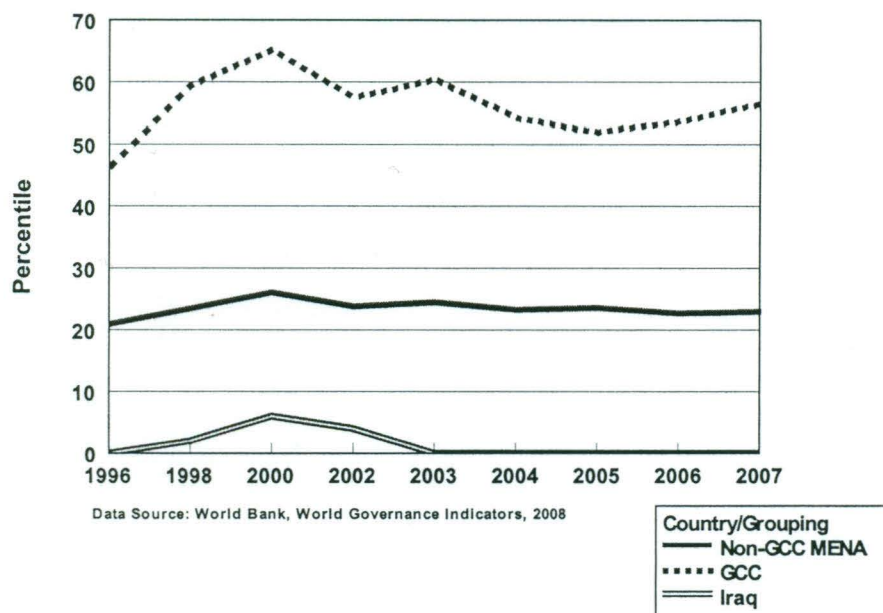


Political stability and absence of violence. This governance cluster combines several indicators that measure perceptions of the likelihood that the government in power will be destabilized or overthrown. Unfortunately, in recent years, the World Bank has placed Iraq in the 0th percentile (Figure 5). By comparison, the MENA average is slightly over the 20th percentile,

relatively unchanged since 1996. On the other hand, perhaps as a result of increased oil revenues, the GCC countries have had some improvement in this area in recent years, reaching the 58th percentile in 2007.

Figure 5

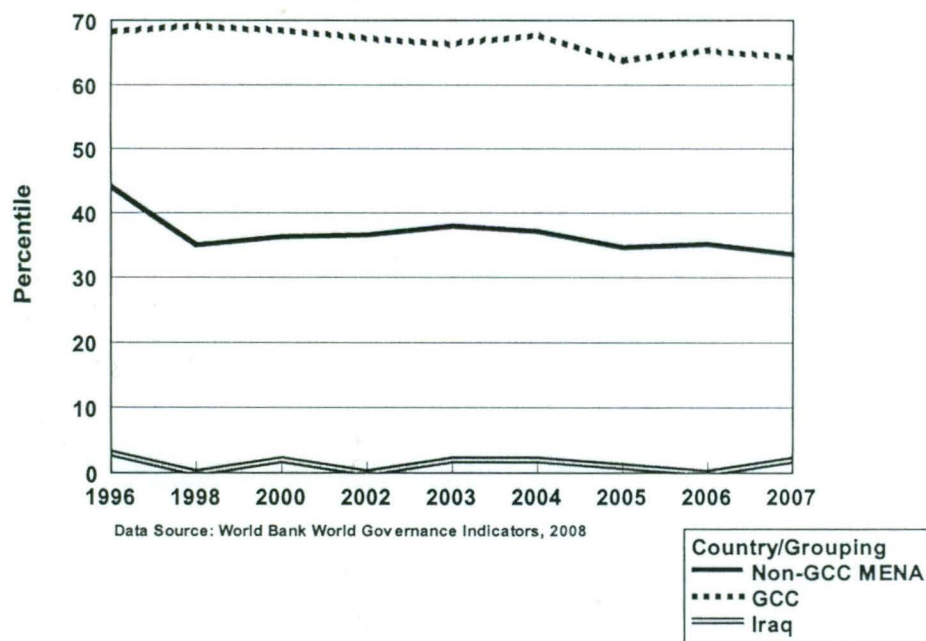
Progress in Governance: Political Stability, Absence of Violence/Terrorism



Government effectiveness. This variable combines aspects of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies. This has been a major area of concern for Iraq—little or no progress has occurred since 2003 (Figure 6), with the country languishing around the 3rd percentile. In contrast, the MENA average is around the 33rd percentile, while the GCC countries are another 30 percentiles higher at the 63rd percentile (2007). Failure in this area has carried over to retard Iraqi reconstruction and development efforts in a broad spectrum of activities.

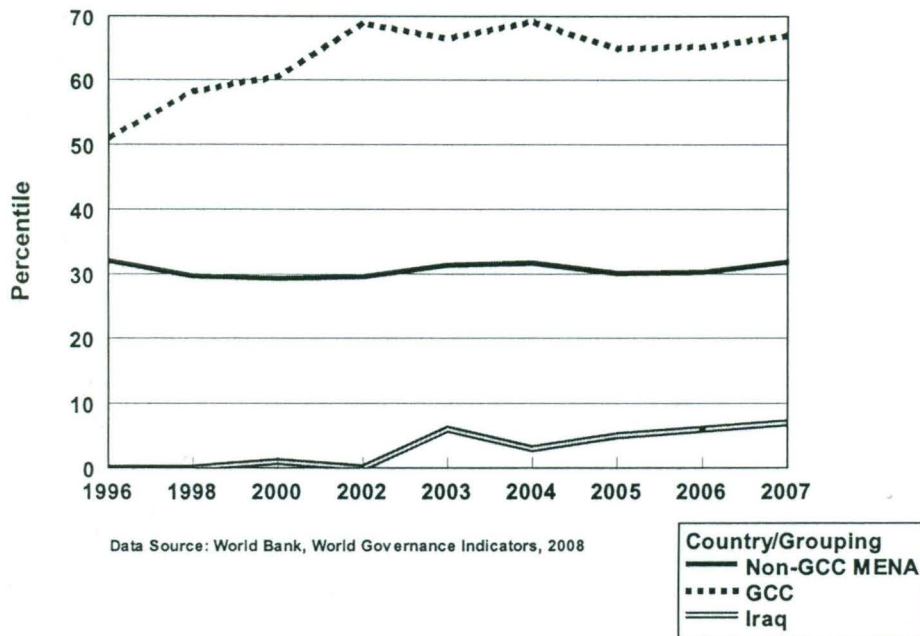
Figure 6

Progress in Governance: Government Effectiveness



Regulatory quality. This aspect of governance focuses on the economic policies themselves. It includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development. Here there is room for a little optimism. Iraq has had slow but steady progress since 2004 winding up at the 8th percentile in 2007 (Figure 7). While considerably below the MENA average 32nd (2007) and the GCC (68th), the country appears to be building on a fairly solid foundation left by the Coalition Provisional Authority.

Figure 7
Progress in Governance: Regulatory Quality

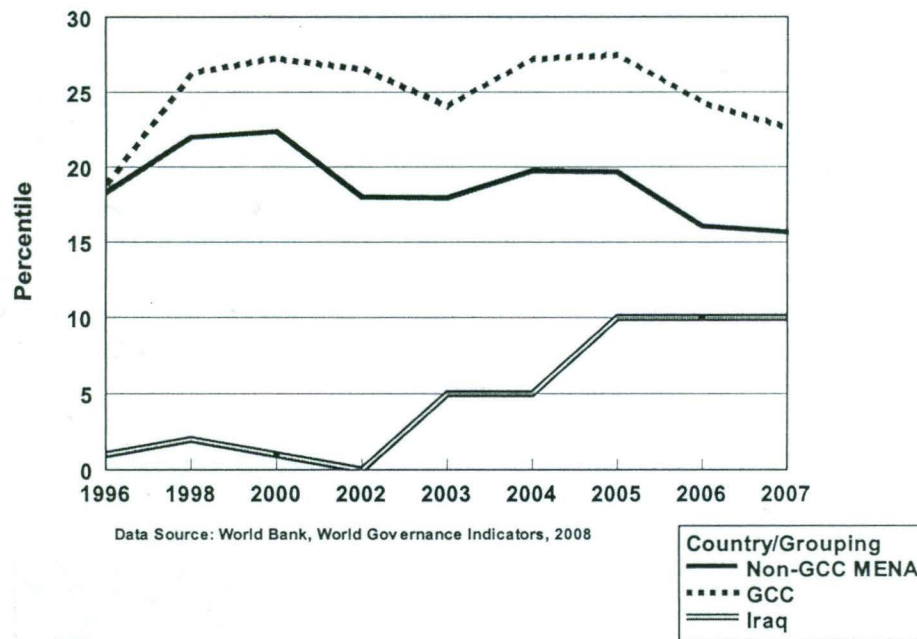


Rule of law. Included in this dimension of governance are several indicators that measure the extent to which the citizens of a country have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contract.

This is the area of governance that Iraq has appeared to make the most progress in recent years. The country moved from the 0 percentile under Saddam in 2002 to 10th percentile in 2005. However, progress has been slow in the last three years, with Iraq holding this position through 2007 (Figure 8). This is also an area of least gap with the MENA and GCC countries. MENA countries declined from the 20th percentile in 2005 to 16th in 2007 while the GCC average has also declined—from 27th in 2005 to 23rd in 2007.

Figure 8

Progress in Governance: Rule of Law

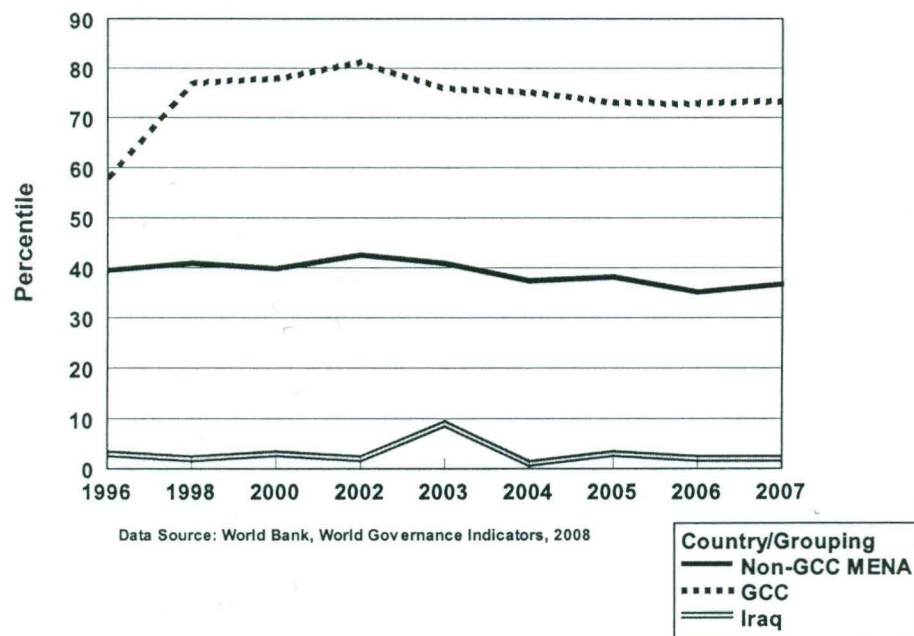


Control of corruption. This dimension of governance measures perceptions of corruption, with corruption defined as the exercise of public power for private gain. It is often a manifestation of a lack of respect of both the corrupter and the corrupted for the rules that govern their interactions, and hence represents a failure of governance.

Corruption is perceived as rampant in Iraq. Under the regime of Saddam Hussein, corruption was a fact of life for every Iraqi and touched on every economic transaction. The country has shown little or no progress. In 2003, the country had reached the 10th percentile, but has subsequently averaged around the 3rd percentile with only a handful of countries considered more corrupt (Figure 9).

Figure 9

Progress in Governance: Control of Corruption



Transparency International's Corruption Perceptions Index³³ is a composite index that draws on multiple expert opinion surveys that poll perceptions of public sector corruption. It scores countries on a scale from zero to ten, with zero indicating high levels of perceived corruption and ten indicating low levels of perceived corruption. Again Iraq has one of the lowest scores (1.9 for 2006), and the situation appears to have gotten worse over time. As of 2006, out of 163 countries examined, Iraq ranked only ahead of Haiti. By 2007 Iraq's score had fallen to 1.4 with only Myanmar and Somalia scoring lower at 1.3. However measured, this legacy of corruption remains a significant obstacle to Iraq's development.

Challenges Ahead

Of the factors noted above deficient governance structures and institutions appear to be the biggest impediment to Iraq's economic recovery. However, since the country's governance standards are so poor, making

³³The results for various years can be found at: www.transparency.org/.

connections between corruption and the slow progress of reconstruction is difficult. Do reconstruction cost overruns stem from corruption or from government incompetence? Does the diversion of reconstruction funds stem from corruption or the absence of the rule of law? Do infrastructure projects fail to attract follow-up private investment due to corruption or the level of violence? Most likely, all these factors are interrelated, thus necessitating a comprehensive approach to combating the country's growing levels of corruption.

For example, in many of the key public ministries that should be playing a lead role in the country's reconstruction, even rudimentary systems of accountability, internal controls, and the rule of law are lacking. The Interior Ministry epitomizes this sad state of affairs. Rather than enforcing the law in an impartial manner, the ministry is driven by political factions. It houses a myriad of competing police and intelligence agencies that pursue various political or sectarian agendas. In the Oil Ministry, corruption at all levels has led to massive losses of revenue. At the border, travelers report that guards often regard bribes as a standard operating procedure. In the Health Ministry, the dire shortage of medicines and drugs in Iraqi hospitals is largely due to the organized theft that takes place at every point in the supply chain. In the Defense Ministry, senior officials are under investigation following allegations that over one billion dollars worth of military equipment has been paid for, but was never delivered to army units.

In the justice system, the police and judges in many areas have reverted to a system where families can only secure the release of their detained relatives on payment of a bribe. It is now routine to hear reports of new officers who have just graduated from the police academy selling their handguns on the black market. Even worse, many in the police are linked to, or are members of, assorted militias and criminal gangs—thus the distinction between the police, the political militias, and criminal groups is often marginal in the minds of Iraqis. In the southern provinces, where UK troops have regularly confronted 'insurgent' attacks, more often than not the insurgents are gangs of criminals or smugglers, loosely affiliated with a Shia militia, mainly concerned with preventing the closure of lucrative smuggling routes by Iraqi and UK forces.³⁴ With oil products still being massively subsidized in Iraq, the smuggling trade is still booming.³⁵

³⁴As the storming of a police station in Basra by British forces in December 2006 showed, parts of Basra's police have been at the centre of the city's criminal activity.

³⁵Robert Looney, 'The Business of Insurgency: the Expansion of Iraq's Shadow Economy,' *The National Interest* 81 (Fall 2005), pp. 67-72.

Additional examples of widespread corruption, shoddy work, and poor management have been documented at length in a series of reports from the US Government's Special Inspector General for Iraq Reconstruction (SIGIR); the Government Accountability Office (GAO), which is the investigative arm of Congress, and CorpWatch, a nonpartisan, not-for-profit monitoring organization.

In his April 2007 report, Stuart Bowen, the head of SIGIR, noted that his agency sampled eight projects and found that seven of them had significant operational problems either because the expensive equipment that was purchased was never used or there were other problems such as plumbing and electrical failures, lack of proper maintenance, and looting.³⁶ What was particularly troubling was that this report was focused only on projects that the administration had touted as successes. In actuality, these successes, should have been described as failures.

- At Baghdad International Airport, where \$11.8 million was spent on new electrical generators, \$8.6 million worth of the project is no longer functioning.
- In a maternity hospital in the northern city of Erbil, a newly built water purification system does not function; an expensive incinerator for medical waste is padlocked, and medical waste—including syringes, used bandages, and empty drug vials—is clogging the sewage system and probably contaminating the water system.
- At the same hospital, a system for distributing oxygen has been ignored by the medical staff, who told inspectors they distrusted the sophisticated new equipment and had gone back to using tried-and-true oxygen tanks—which are stored unsafely throughout the building.
- Expensive generators are missing from the Iraqi Camp Ur military base, having been hauled off to another post. Also at Camp Ur, three modular buildings constructed at a cost of \$1.8 million were dismantled and removed with no explanation given.

³⁶Special Inspector General For Iraq Reconstruction, *Moving Beyond the IRRF* (Washington, SIGIR, April 30, 2007). This source is the basis of the summary of SIGIR findings reported in the paragraphs that follow.

- Barracks renovated for enlisted soldiers are already in disrepair, just a year after being handed over to the Iraqi Army.

Because these latest problems presumably developed after the US turned the projects over to the Iraqi government, there is widespread concern over the ability of the various ministries to sustain the reconstruction effort. How much of the difficulty can be attributed exclusively to corruption, however, is difficult to assess.

In its report, SIGIR concluded that the Iraqi civil service is hampered by inadequately trained or unskilled staff. 'Iraqi government institutions are undeveloped and confront significant challenges in staffing a competent, nonpartisan civil service; effectively fighting corruption; using modern technology; and managing resources effectively.'³⁷ Furthermore political and sectarian loyalties have jeopardized the ministries' ability to provide basic services and build credibility among Iraqi citizens. In short, government ministries are being staffed with party cronies and their budgets are being used as sources of power for political parties.

SIGIR in particular noted that patronage in the ministries has led to staff instability, as key personnel are replaced when the government changes or a new minister is named. Some Iraqi ministries, including the Ministries of Interior, Agriculture, Health, Transportation, and Tourism, are being led by ministers who are aligned with political parties that are hostile to the international presence. These ministers have used their positions to pursue partisan agendas that conflict with the goal of building a government that represents all ethnic groups.

In this environment, SIGIR notes that "Corruption jeopardizes future flows of needed international assistance and reportedly undermines the government's ability to make effective use of current reconstruction assistance." Other factors contribute to the corruption problem: an ineffective banking system that leaves the government dependent on cash transactions, opaque and obsolete ministry procurement systems, and inadequately resourced accountability institutions such as the ministries' inspectors general.

Aside from the lack of security, corruption is the biggest threat to progress in stabilizing Iraq. SIGIR reports that Iraq has been losing US \$4 billion to corruption every year since the overthrow of Saddam Hussein. The country now has more than 1,400 criminal corruption cases open,

³⁷US Government Accountability Office, *Stabilizing and Rebuilding Iraq: Conditions in Iraq are Conducive to Fraud, Waste, and Abuse*, Washington D.C., 23 April 2007, p.22.

involving about \$5 billion. Paying bribes for services is now standard practice. Corruption is particularly endemic in the oil sector, with the Ministry of Oil hit by smuggling rackets that have reduced state oil earnings. At least 10 percent of refined fuels are sold on the black market and about 30 percent of imported fuels are smuggled out of Iraq.³⁸

On paper, Iraq has a strong set of institutions designed to address corruption issues:

- The Board of Supreme Audit dates back to the 1920s.
- The coalition installed inspectors general in all Iraqi ministries and also created a Commission on Public Integrity (CPI) to investigate the most serious cases of corruption.³⁹
- Since April 2003, a large amount of international assistance has gone into providing these institutions (and the Iraqi courts and police) with training, equipment and technical advice.

Nonetheless, these anti-corruption institutions are very weak and easily influenced by political pressures, and it is common in today's Iraq to use charges of corruption to discredit officials who stand in the way of political objectives. This forces the coalition to remain the watchdog of last resort. However, in some ministries, such as Health and Interior, the US-appointed inspectors general have become political players rather than independent guarantors of probity.⁴⁰

The breadth and depth of corruption has infuriated Iraqi citizens, who see politicians and officials growing rich while services decline. This has fed disillusionment with the US, UK, and Coalition presence, and may have contributed to support for militias and insurgents. Corruption also alienates international donors, who see much of their investment in Iraq going to waste.

In order to address this issue, Iraq's key international partners have suggested a range of schemes that include training investigators, protecting judges and witnesses, and reforming procurement and financial processes

³⁸James Glanz and Robert F. Worth, 'Attacks on Iraq Oil Industry Aid Vast Smuggling Scheme', *New York Times*, 4 June 2006.

³⁹See Coalition Provisional Authority Order Number 55, *Delegation of Authority Regarding the Iraq Commission on Public Integrity*, 27 Jan. 2004.

⁴⁰"Iraq: Corruption Hurts Effort to Rebuild State," *Oxford Analytica*, April 21, 2007, p. 1

to remove opportunities for fraud. However, without the political will of those at the top of the incoming Iraqi government, such technical assistance will be of little use. The government's ability, let alone its determination to crack down on corruption, remains very much in doubt.

Taking a substantial share of oil revenues (20-25%) out of the hands of corrupt politicians and placing it in that of the population at large is probably the most powerful anti-corruption policy available today. A direct distribution scheme of this type would also provide a number of immediate benefits to the economy and the recovery process:

1. The Iraqi people would have increased incentive to protect the country's oil facilities by providing intelligence on insurgent groups attempting to disrupt the production and flow of oil.⁴¹
2. It might even help stem the insurgency, especially if much of that activity is driven by Sunni fears that they will receive considerably less than their accustomed amount under the new Constitution.
3. Men and women would receive equal distributions.
4. It would establish an irrevocable personal identity under the law—essential for establishing titled property rights, bank accounts, human rights protection, voter lists and taxpayer lists.
5. It would expand banking and credit access for small and medium business.
6. It could help offset public resistance to gas price increases which will be needed to cut back oil smuggling. A related benefit is that it would also greatly help the government cut back on gas subsidies which currently amount to billions of dollars a year.

⁴¹Gordon O.F. Johnson, "Iraq's Oil Revenues Should Empower the People," speech, Heritage Foundation June 3, 2004.

7. Without equitable distribution of oil revenues, competition among various groups for oil money could turn ugly and could even erupt to violent conflict in Iraq. Rifts over oil revenues already run deep, as Iraqi Kurds, Arabs, and Turkmen struggle for control of oil-rich Kirkuk.⁴²
8. Citizens eligible for fund payouts would have an incentive to monitor the government and participate in the political process to guard the value of their entitlement.
9. Oil funds are likely to encourage efficiency in the petroleum sector. Since the size of payments to citizens will depend on the efficiency of the oil industry, this should contribute to political pressure to improve efficiency.
10. Oil funds are expedient—rather than the long time intervals needed to improve government accountability and anti-corruption drives, they can be put in place immediately. They are doubly desirable when governance is weak, and the need for institutions to handle oil revenues is immediate.

A direct oil distribution scheme makes particular sense at this time given the fact that one of the main consequences of Iraq's deficient governance, especially with regard to government fiscal operations has been an inability to implement capital projects. Expenditure data from Iraq's Ministry of Finance indicates that between 2005 and 2007, Iraq spent only 24 percent of the \$27 billion it budgeted for its own reconstruction efforts.⁴³

Total government spending for capital improvements increased from 23 percent in 2005 to 28 percent in 2007. However, Iraq's central ministries, responsible for security and essential services, spent only 11 percent of their capital investment budgets in 2007—a decline from similarly low spending rates of 14 and 13 percent in 2005 and 2006, respectively. Spending rates of central ministries that are critical to the delivery of essential services varied from the 41 percent spent by the Water Resources

⁴²Protecting the Future: Constitutional Safeguards for Iraq's Oil: An Iraq Revenue Watch Report, May 2005.

⁴³Gene L Doraro, Securing, Stabilizing, and rebuilding Iraq—Progress Report: Some Gains Made, Updated Strategy Needed (Washington: United States Government Accountability Office, July 23, 2008), p. 9.

Ministry to the less-than-one percent spent by the Ministries of Oil and Electricity in 2007.

As noted earlier, due to increased production rates and higher oil prices, Iraq may finish 2008 with a cumulative budget surplus of as much as \$80 billion.⁴⁴ Ironically Iraq has become one of the few countries in the world that does not face a conventional financial constraint—the country's main problem lies in overcoming institutional obstacles to converting its riches into jobs and sustainable economic growth.

Assessment

Clearly some economic progress is being made in Iraq. Can the incremental improvements over the last year or so somehow be the basis for the creation of a virtuous circle of improved standards of living, leading to a lessening of violence and higher rates of investment and economic expansion? While there are some encouraging signs, economic recovery is still very fragile.

What accounts for the slow pace of recovery and growth until perhaps mid-to late 2007? As noted, deficient governance structures have been a major obstacle to progress. On a more practical level, the failure to integrate economic programs more tightly with political and military dimensions is another major factor. Since the overthrow of Saddam Hussein, the economy has largely been an afterthought; the result being that political and military gains were hard to sustain in an environment of grinding poverty and unemployment.

One of the main lessons learned from the British experience in Southern Iraq was that:⁴⁵

In conditions of economic stagnation the security forces find that they are dealing with general public order issues caused by significant numbers of ordinary disgruntled Iraqis, rather than the pure terrorist threat. What is required is a balanced approach with equal focus on the redevelopment of the domestic economy as well as the rebuilding of the domestic security forces.

Fortunately, both the U.S. and the Iraqis have heeded these warnings and, around the time of the Crocker report, economics was being introduced and integrated into the country's counter-insurgency strategy. The initial results of this refocus on economic development have been quite encouraging. There are many other policies like the oil distribution scheme that are available and could complement a broad based economic strategy. Hopefully, the next picture that the Crocker report will present to Congress will be of a half full, rather than half empty, glass.

⁴⁴Bushra Juhi, "Iraqi Official Defends Spending Surplus," *Kansas City Star*, August 7, 2009.

⁴⁵Andrew Alderson, "The Economy, Stupid," *Parliamentary Brief*, October 2007, p. 9.